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# VIRGINIA LAW REVIEW

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ARE DIVIDENDS IN THE STOCK OF REORGANIZED CORPORATIONS INCOME?—A recent decision of the Supreme Court of the United States involved the question of the taxability, as income, of a dividend consisting of stock in a corporation other than the declaring corporation.<sup>1</sup> In *Eisner v. Macomber*<sup>2</sup> it was held, four judges dissenting, that where a dividend was issued in stock of the declaring company, such a transaction was "no more than a book adjustment, in essence not a dividend but rather the opposite";<sup>3</sup> that the holdings of the individual stockholders were not increased thereby, since, by the increase in number of shares, there was a consequent proportionate diminution of the value of each; and that the accumulated profits of the corporation, so far from being distributed to the stockholders, were permanently capitalized and made subject to the risks of the business—a proceeding entirely foreign to the proper conception of income.<sup>4</sup> This decision seems eminently sound.

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<sup>1</sup> *United States v. Phellis*, 42 Sup. Ct. 63 (1921).

<sup>2</sup> 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521, 9 A. L. R. 1570 (1920).

<sup>3</sup> 252 U. S. 210 (1920).

<sup>4</sup> The nature of a stock dividend was also well set forth in *Gibbons v. Mahon*, 136 U. S. 549, 559, 560 (1890): "A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished and their interests are not increased. \* \* \* The proportional interest of each

But the Macomber Case is authority only for the proposition that where a dividend is in *stock of the declaring corporation*, it is not income and therefore not taxable. The case presently to be discussed was one in which a dividend was issued in the *stock of another company*. Before considering the latter, let us see the attitude of the Court toward the taxation of stock dividends before and after the Income Tax Act of 1916.

*Towne v. Eisner*<sup>5</sup> was a case which arose before the Act of 1916, at which time the law made no special provision for the taxation of stock dividends. The Court had no difficulty in deciding that, since Congress did not mention stock dividends as coming within the purview of the Income Tax Act of 1913, such dividends were not taxable, on the ground that they were capital rather than income.

But Congress was not slow to indicate its disposition to tax dividends in stock of the declaring corporation. Before the above case was decided, the Act of 1916 was passed, specifically providing for the taxation of dividends and defining them as any distribution made or ordered to be made "whether in cash or in stock of the corporation, joint stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value."<sup>6</sup> In *Eisner v. Macomber*<sup>7</sup> the Court was called upon to determine the constitutionality of this Act. Construing it, the Court held that, inasmuch as Congress derives its power to legislate from the Constitution alone, it cannot go beyond the limits of the Constitution in exercising this power; and that no mere assertion of Congress can make that income which is not such in fact. In other words, the Act of 1916 was declared unconstitutional in so far as it called for the taxation of stock dividends, and the claimant was exempted as in the earlier case.<sup>8</sup>

In *United States v. Phellis*,<sup>9</sup> a Delaware corporation took over all the assets of a prosperous New Jersey company and assumed all its liabilities except its capital stock and funded debt. The old company acquired enough debenture stock of the new concern to liquidate its bonds, retire its preferred stock, and cover its common stock which the stockholders retained. In addition, the New Jersey corporation paid to its stockholders two shares of the common stock of the Delaware company for each share of the old common stock held by them. The stockholders and officers of the two concerns were identical, and the old company did no business thereafter. It was held that the claimant's stock in the new corporation, distributed to him as a shareholder of the old, was income and taxable as such.<sup>10</sup>

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shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of new ones."

<sup>5</sup> 245 U. S. 418, 38 Sup. Ct. 158, 62 L. Ed. 372, L. R. A. 1918D, 254 (1918).

<sup>6</sup> United States Compiled Statutes (1916), § 6336b (a)

<sup>7</sup> *Supra*.

<sup>8</sup> *Towne v. Eisner, supra*.

<sup>9</sup> *Supra*.

<sup>10</sup> In several recent cases wherein a capital interest in a corporation was disposed of at a figure greater than the value of such capital inter-

The facts of this case differed from those of *Eisner v. Macomber*<sup>11</sup> only in this: that the dividend was issued in the stock of another company rather than the existing one. Therefore, since the claimant was taxed on his dividend in the later case and exempted in the earlier, the Court must have distinguished the later case on the ground of the separateness of the corporation which declared the dividend from the corporation in which the dividend was payable. Two excerpts from the opinion show that this was the real question involved. In speaking of the issue of stock in the Delaware corporation, it was said:<sup>12</sup>

"But when this common stock was distributed among the common stockholders of the old company as a dividend, then at once—*unless the two companies be regarded as substantially identical*—the individual stockholders of the old company, including claimant, received assets of exchangeable and actual value severed from their capital interest in the old company, proceeded from it as the result of a division of former corporate profits, and drawn by them severally for their individual and separate use and benefit. Such a gain resulting from their ownership of stock in the old company, and proceeding from it, constituted individual income in the proper sense." (Italics ours.)

And again:<sup>13</sup>

"There is nothing to warrant us in treating this separateness as imaginary, *unless the identity of the body of stockholders and the transfer in solido of the manufacturing business and assets of the old company to the new necessarily have that effect.*" (Italics ours.)

The case was an extremely close one and the lines were sharply drawn. Clearly, the decision was sound if the premise (viz.: the separateness of the two corporations) was warranted. It is evident that, if the New Jersey and Delaware companies were distinct, the "dividend received by claimant was a gain, a profit derived from his capital interest in the old company, not in liquidation of the capital, but in distribution of accumulated profits of the company."<sup>14</sup> It is equally obvious that, if they were substantially identical, the

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est on March 1, 1913, the profit was held to be taxable as income. *Merchants' Loan and Trust Co. v. Smietanka*, 255 U. S. 509 (1921); *Eldorado Coal & Mining Co. v. Mager*, 255 U. S. 522 (1921); *Goodrich v. Edwards*, 255 U. S. 527 (1921); *Walsh v. Brewster*, 255 U. S. 536 (1921). In the first of these cases, a definition of income, enunciated by the Court in *Eisner v. Macomber*, 252 U. S. 189, 207 (1921) was approved: "Income may be defined as the gain derived from capital, from labor, or from both combined, *provided it be understood to include profit gained through a sale or conversion of capital assets.*" (Italics supplied in *Merchants' Loan & Trust Co. v. Smietanka*, *supra*.)

<sup>11</sup> *Supra*.

<sup>12</sup> *United States v. Phellis*, 42 Sup. Ct. 63, 66 (1921).

<sup>13</sup> 42 Sup. Ct. 67.

<sup>14</sup> 42 Sup. Ct. 68. See *Peabody v. Eisner*, 247 U. S. 347, 38 Sup. Ct. 546, 62 L. Ed. 1152 (1918).

distribution of stock was merely an increase of capital holdings, and in no sense income.<sup>15</sup>

The perplexing question is the interpretation of, and the result flowing from, the act by which the Delaware corporation came into being. Was it *in fact* a distinct company? It is believed that the separateness was more in form than in substance.

The name of the new corporation was the "E. I. du Pont de Nemours & Co.," while the old company was known as the "E. I. du Pont de Nemours Powder Co." So far as appears, the purposes of the new concern differed in no respect from those of the old. The fact that the new company had an authorized capital stock much larger than that of the old would seem to be immaterial, although urged by the Court. The Court makes much of the fact that the Delaware corporation was "formed under the laws of a different state, which necessarily imports a different measure of responsibility to the public, and presumably different rights between the stockholders and company and between stockholders *inter sese*, than before."<sup>16</sup> Curiously enough, however, in another case<sup>17</sup> decided the same day, where a new company was incorporated in the same State as an old one, the importance, in the instant case, attached to the diversity of States of incorporation was passed over in silence. On principle, the point seems irrelevant.

It will be remembered that the stockholders and officers of the two companies were identical. It is interesting to note how this point (which seems to us to be material) was regarded by the Court. The Court seems to treat the identity as nothing more than a coincidence, holding that, while there was no present change of officers or stockholders, "a continuation of identity in this respect depended upon continued unanimous consent or concurrent action of a multitude of individual stockholders actuated by motives and influences necessarily to some extent divergent."<sup>18</sup> The attempt is thus made to explain away the initial identity of officers and stockholders by affirming that they are subject to change. The possibility, if not the certainty, of a change in the membership of the Delaware corporation is to be admitted. But the continuance of the personnel of the Delaware corporation as a criterion by which to pass upon its identity with the New Jersey company does not seem sound. It might as well be argued that a corporation is not identical with itself after one of the original stockholders has disposed of his interest to a third person. But it is fundamental in the law of corporations that the identity of a corporation is not disturbed by a change, however extensive, in the personnel of its members.<sup>19</sup>

Only one case is cited as authority for the position taken.<sup>20</sup>

<sup>15</sup> *Southern Pacific Company v. Lowe*, 247 U. S. 330 (1918); *Gulf Oil Corporation v. Lewellyn*, 248 U. S. 71 (1918).

<sup>16</sup> 42 Sup. Ct. 67.

<sup>17</sup> *Rockefeller v. United States*, 42 Sup. Ct. 68 (1921).

<sup>18</sup> 42 Sup. Ct. 67.

<sup>19</sup> Blackstone compares a corporation, with its constantly fluctuating membership, to the river Thames, which "is still the same river, though the parts which compose it are changing every instant." 1 BL. COM. 468.

<sup>20</sup> *Peabody v. Eisner*, *supra*.

There the Union Pacific Railroad Company, which had large holdings in the Baltimore and Ohio Railroad Company, paid to its stockholders a dividend, part of which consisted of preferred and common stock of the Baltimore and Ohio. This stock was properly held income "since the dividend of Baltimore and Ohio shares was not a stock dividend but a distribution *in specie* of a portion of the assets of the Union Pacific, and is to be governed for all present purposes by the same rule applicable to the distribution of a like value of money."<sup>21</sup> But the Union Pacific and the Baltimore and Ohio were admittedly distinct corporations. So that the citation of this case as authority for the Phellis Case, *wherein the identity of the corporations is the mooted question*, seems to be a very free use of judicial construction.

The strongest argument for the distinctive character of the Delaware company was the fact that the claimant could dispose of any or all of his stock therein without losing his capital interest in the New Jersey concern. This is not true, as pointed out by the Court, if the dividend is issued in stock of the declaring corporation. To illustrate: Suppose a stockholder has 100 of the 1000 shares of a corporation whose capital stock is \$100,000. This is a one-tenth interest. Now suppose that the company declares a 200% dividend, payable in its own stock. He would then have 300 shares in a corporation whose capital stock is \$300,000.—still a one-tenth interest. If, however, he should sell half of his new shares, his interest would be reduced to one-fifteenth. In order to retain his one-tenth interest he would be obliged to keep all his new stock. Now change the facts by supposing that the 200% dividend is in the stock of another corporation. He would then have a one-tenth interest in each company; but the maintenance of such interest in the old company would not depend upon his retaining the new shares.

In the illustrations just given, the Phellis Case falls under the second head. It was upon the fact that the claimant could sell any or all of his new shares without impairing his capital interest in the New Jersey company that the Court distinguished this case from that of *Eisner v. Macomber*.<sup>22</sup> This is true if his capital interest in the old corporation is the one that should govern. But it would seem that the real corporation *in substance*, after the reorganization, was the Delaware company, and that the claimant's real capital interest was the stock in this company issued to him. And why? The New Jersey company existed merely in name thereafter. It did no further business. Its stock dropped from \$795 to \$100—the difference being taken up by the value of the two shares of Delaware stock—and, since the old company was no longer active, there would seem to be little hope of its stock advancing. If then the claimant's real capital interest was in the Delaware corporation, the distinction would not be well founded. For the claimant could no more sell a single one of his 200 new shares without lessening his one-tenth interest in the new company than he could where the

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<sup>21</sup> 247 U. S. 349, 350.

<sup>22</sup> *Supra*.

dividend was in stock of the declaring corporation. From this aspect of the case, the transaction would seem to be more in the nature of a reorganization of the New Jersey corporation than of the formation of a new and distinct company. Such was the view taken in the dissenting opinion.<sup>23</sup>

So that, upon viewing the case in its entirety, the actual separateness of the New Jersey and Delaware corporations, upon which the soundness of the decision rests, may well be questioned. The better view would seem to be that of Mr. Thomas Reed Powell, who regards the apparent distinctive character of the new company as formal only. He says:<sup>24</sup>

"The law knows a number of situations in which one suspects that courts seek to preserve a balance by leaning now to one side and now to another. So it may well be in determining whether there has been an adequate realization of income. If the taxpayer is favored in respect to one type of dividend, why not favor the government in respect to another? Let one close decision go in favor of the home team and the next in favor of the visitors."

S. M. G.

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DELEGATION OF LEGISLATIVE POWER BY MUNICIPAL CORPORATIONS.—It is a well settled doctrine of the law of municipal corporations that any attempt on the part of such a corporation to delegate its power to individuals is void.<sup>1</sup> But when such a delegation occurs, and what constitutes a delegation in the prohibited sense, is a question with which the courts have had endless trouble.

Ordinances regulating the erection of buildings at the request or with the consent of adjoining property owners present many nice questions before the courts, with conflicting results. Some cases are in direct conflict, while from others some general principles might be drawn.

The United States Supreme Court decided in 1912 that a municipal ordinance providing that the committee on streets should, upon a written request of two-thirds of the property owners, establish a building line, within which all structures must be erected, was invalid as a delegation of authority.<sup>2</sup> This was a clear case of delegation. The committee was powerless until the individual prop-

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<sup>23</sup> Justice McReynolds' view conformed to that of the Court of Claims, which said: "We think the whole transaction is to be regarded as merely a financial reorganization of the business of the company and that this view is justified by the power and duty of the court to look through the form of the transaction to its substance." 42 Sup. Ct. 63, 68.

<sup>24</sup> 35 HARVARD LAW REVIEW 363, 391, 392. For discussions of *Eisner v. Macomber*, see 33 HARVARD LAW REVIEW 885; 20 COLUMBIA LAW REVIEW 536; 18 MICHIGAN LAW REVIEW 689; 29 YALE LAW JOURNAL 735; 7 VIRGINIA LAW REVIEW 134.

<sup>1</sup> *Lowery v. Lexington*, 116 Ky. 157, 75 S. W. 202 (1903); *I DILLON, MUNIC. CORP.* (5th ed.) § 244.

<sup>2</sup> *Eubank v. City of Richmond*, 226 U. S. 137 (1912).